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DEPARTMENT FOR EUR/SCE (ERIN KOTHEIMER AND YOULIANA IVANOVA)
PASS TO TREASURY FOR VIMAL ATUKORALA

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SUBJECT: GOA'S 2008 BUDGET INCREASES INFRASTRUCTURE AND SOCIAL
SPENDING

Summary

1. The GOA's 2008 budget increases both spending and borrowing as the government looks toward national elections in 2009. Further tax reductions and a dramatic increase in spending on infrastructure projects as well as social and defense programs to meet NATO accession criteria will be financed by projected increases in revenue and debt financing. The opposition has criticized the new budget for running up the country's national debt. However, the real challenge for the government will be the successful implementation of the budget. Prior public investment performance has been poor. End Summary.

Budget Based on Continuing
Growth and Low Inflation

2. The Albanian Parliament approved the final version of the 2008 national budget on November 26; the budget was approved on time for the second year in a row. The vote in Parliament fell along predictable party lines, 66 votes in favor and 34 against. The \$4.1 billion budget is marked by higher revenues compared to last year and increased borrowing is expected to enlarge the budget deficit to 7.9% of GDP. The new budget anticipates a real growth rate of at least 6% in 2008 and an inflation rate within a range of 3-4%. It also foresees a modest reduction of unemployment to around 13% (from about 14% currently) and an improving trade deficit. Both outcomes would continue slow but steadily improving trend lines regarding unemployment and the country's trade imbalance over the last few years.

Revenue Growth Accelerates

3. The new budget forecasts total revenues to be \$3.15 billion (26.4% of GDP). Revenues are expected to grow by 7.5% over 2007's projected revenues and 24% over revenue generated in 2006. These anticipated revenue targets, in both absolute and relative terms, would be the highest amount collected during the last decade. If achieved, they would occur as new tax policies reduce domestic tax rates by 50% and a flat tax of 10% for both corporate and personal tax rates is adopted. (Note: The new tax rates will give Albania among the lowest tax burdens in the region.) According to Finance Minister Bode, tax reduction will save the business community up to \$133 million or 1.1% of GDP.

4. This projected revenue growth is based mainly on estimated higher revenues collected from the tax and customs agencies as well as from local governments. The further modernization of the fiscal system, based on the implementation of tax reform policies (and a Millennium Challenge Account project), and efforts to reduce the informal sector (gray economy) are also factors driving higher revenue collection. Tax collections will account for almost 92% of

total government revenues. Tax and customs revenues in 2008 are forecast to reach \$2.16 billion - 12 percent more than expected 2007 results - representing 18.2% of GDP.

Capital Spending Jumps

15. The 2008 budget increases spending significantly, especially for capital projects. The government's goal is to reach an optimal level of spending in public investments consistent with other rapidly developing countries. The 2008 budget will total \$4.1 billion, representing 34.3% of GDP, marking an increase of almost 3% in terms of GDP and a 20% increase in straight dollar terms compared to 2007 projections. Although the increased spending is supported by higher revenues, substantial increased borrowing is also part of the GOA's fiscal planning. In total, debt financing will jump to \$740 million, more than triple the amount borrowed in 2007.

16. Capital expenditures get the lion's share of this boost and are forecast to hit \$1.16 billion (9.8% of GDP), 50% higher than in the 2007 budget and triple what was spent in 2006. In 2008, capital spending will be one-third of the total budget, up from one-seventh two years ago. The increased expenditures aim to boost important infrastructure projects and support economic reforms in the framework of NATO and EU integration. The Ministry of Transportation and Public Works will be the main recipient of public money: \$810 million, 95% of which will go for capital investments, roads, water supply projects, sewage treatment and housing. Road infrastructure projects alone are expected to receive \$650 million, although more than half of this amount (\$353 million) will go to the high-profile road project connecting Durres to Kosovo, the major portion of which is being constructed by a U.S./Turkish consortium led by Bechtel Corporation. Several other nationwide road projects will also start in 2008.

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17. The defense sector will receive \$241 million or 2% of GDP, which is in line with NATO accession requirements two years ahead of the GOA's self-imposed 2010 deadline. (Note: Additional funding channeled to the Ministry of Defense through the Ministry of Finance, earmarked for payment of pensions to retired officers raises this total to 2.07% of GDP, exceeding Albania's NATO requirements.) Total spending for the defense sector will have doubled over the last four years, a sign of the GOA's determination to join NATO.

18. As in previous years, health and education will remain priority sectors. The education sector will receive \$475 million, or 4% of GDP compared to 3.4% in 2006. Spending for education will grow by 17% compared to 2007. The health sector will receive \$345 million or 2.9% of GDP, up from 2.1 percent in 2006. The 2008 budget also provides for significant increases in pensions and certain public sector salaries, building on past increases that aim to double them by 2009. The agriculture sector, an important contributor to GDP, still suffers from government inattention; total spending is 0.55% of GDP or \$65 million.

Growing Debt, Poor Public Administration Worry Critics

19. The GOA plans to borrow \$730 million to support the expansion of public investment next year. At the end of 2007, total debt amounted at 531.4 billion lek (\$5.9 billion) or 54% of GDP. In 2005, the ratio to GDP was 57%. Higher borrowing will translate into a higher budget deficit, which is forecast to reach 7.9% in 2008, reversing a positive trend experienced during the last year when the budget deficit was under 4%.

110. The GOA's decision to sharply increase borrowing has been a major issue for the opposition Socialist Party. The Socialists claim that over-inflated public spending will create a serious threat to the macroeconomic stability Albania has achieved since the economic chaos of the late 1990s and could grow into a fiscal burden for future generations. The opposition has also criticized the

Democratic Party-led majority for the government's lack of capacity to implement public investments and points to the GOA's unsatisfactory budgetary track record since it came to power in ¶2005. Specifically, the opposition - and other critics, as well - contend that the government's inability to efficiently spend public money and the concentration of spending during the last month of the fiscal year contribute to inflation and threaten the country's financial health.

Comment

¶11. The 2008 budget reflects the determination of the government to expand public investments to foster economic growth. However, politics is the main factor driving GOA budget priorities as Prime Minister Berisha prepares to lead his government into national elections in 2009. Albania, which has enjoyed impressive macroeconomic stability in recent years, requires rapid improvement of its dilapidated infrastructure if it is to build on the economic growth of the past decade. Improving public administration performance and keeping debt pressures manageable will remain pressing challenges for the government. End Comment.
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